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The Oil Market Outlook Through 1988

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An Intelligence Assessment

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*GI 85-10209
August 1985*

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The Oil Market Outlook Through 1988

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An Intelligence Assessment

This paper was prepared by [redacted]
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contribution from [redacted] OGI. Comments
and queries are welcome and may be directed to the
Chief, Strategic Resources Division [redacted]
[redacted]

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**The Oil Market Outlook
Through 1988**

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Key Judgments

*Information available
as of 1 August 1985
was used in this report.*

We expect the oil market to remain weak at least through 1986, resulting in continued downward pressure on prices. As a result, OPEC will have a difficult time preventing a further drop in nominal oil prices over the next 18 months, given the negative market outlook:

- Oil consumption will remain fairly steady, while non-OPEC oil supplies are expected to rise by nearly 1 million barrels per day (b/d) this year and perhaps by 500,000 b/d in 1986.
- Substitution of other fuels for oil is still occurring at a rapid pace, and investments in conservation over the last several years continue to improve energy efficiency—albeit at a declining rate.

Under these circumstances, demand for OPEC oil probably will approximate only 16-17 million b/d in both 1985 and 1986, compared with almost 32 million b/d in 1979—an outlook that will exacerbate financial strains on several OPEC countries and discord within the organization

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The key to preventing a major price decline rests with Saudi Arabia and other OPEC producers. Thus far Saudi Arabia has borne the brunt of production cuts needed to maintain prices, but Riyadh alone cannot continue to reduce output to support current price levels. Indeed, the Saudis have informed OPEC that they will no longer act as the organization's swing producer and have threatened to almost double output if other members do not abide by established price and production guidelines. Financial pressures will make it difficult for a number of OPEC countries to remain within their allotted production quotas for any extended period. At a minimum, we expect further small declines in nominal oil prices during the next two years. A decision by Riyadh to follow through on its threats and abandon its current price management role would cause a very sharp decline in oil prices. We are uncertain how far prices might fall under this scenario, but some industry experts indicate that prices could drop well below \$20 per barrel

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Although the results of an oil price decline would generally be favorable, a sharp fall in nominal prices in 1985-86 could require some economic and political adjustments. Significantly lower prices certainly would spur economic growth, dampen inflationary pressures, and reduce Soviet hard currency earnings, but could also renew strains in the financial community as heavily indebted oil exporters endure new hardships. Economic and political instability could also increase in some oil-exporting countries.

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If OPEC gets through the next 18 months or so without a price collapse, downward oil price pressures could ease in the 1987-88 period. Most forecasters expect non-OPEC oil supplies to decline slightly, which by causing demand for OPEC oil to rise very gradually should help encourage producer cooperation. Nevertheless, we expect ample capacity to keep market conditions soft and cause a continued erosion in real oil prices over the period. In the long term, lower oil prices will slow conservation and substitution, hastening a return to a period of industrial country dependence on insecure Persian Gulf oil supplies and heightening the vulnerability of the developed nations to major oil supply interruptions toward the end of the decade.

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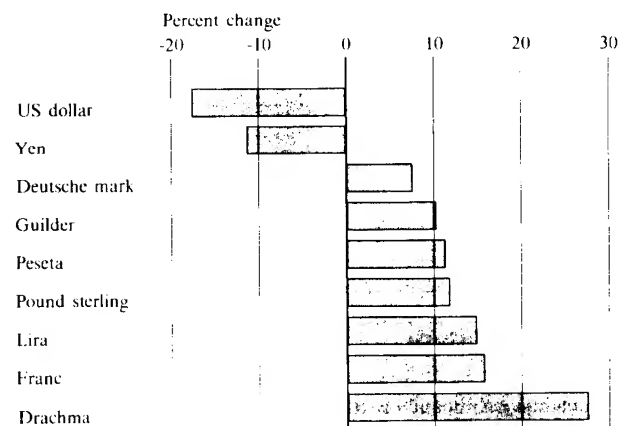
The Oil Market Outlook Through 1988

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Introduction

Weak oil demand, rising non-OPEC supplies, and substantial excess productive capacity in OPEC countries continue to exert strong downward pressure on oil prices. A nearly 50-percent drop in demand for OPEC oil since 1979 has produced severe strains within the organization. Although OPEC members have established production allocation systems and reduced official prices during the last three years, the unwillingness of most members to adhere to production and price guidelines has kept prices soft. As OPEC's swing supplier, Saudi Arabia has borne the brunt of demand cuts, but, with production averaging only about 2.5 million barrels per day (b/d) in recent months, Riyadh is unwilling to singlehandedly support the current price structure. OPEC now has far less leverage to deal with threats to its price structure, but decisions taken by these producing countries will continue to play a major role in determining oil prices.

Figure 1
Crude Oil: Change in Cost Per
Barrel in Local Currency, January
1985 Compared With February 1983^a



^a Based on price of Arab Light crude.

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Market Pressures Build

Following a 2-percent rise in non-Communist oil consumption last year to 45 million b/d, consumption so far in 1985 is running below year-earlier levels and more than 500,000 b/d less than most oil companies had expected. The slowdown in economic activity in the United States, continued conservation gains, and substitution away from oil contributed to an estimated 1- to 2-percent drop in oil use in the industrialized countries last winter compared with year-earlier levels. Preliminary data indicate second-quarter oil sales in the industrialized countries were 3 percent below year-earlier levels. The strong US dollar also depressed West European oil demand by pushing up oil prices in local currencies (figure 1).

Lower fuel oil use is the primary factor behind the drop in total consumption. First-quarter data indicate fuel oil sales in the major industrialized countries were 15 to 20 percent below year-earlier levels, while other key product sales were above 1984 levels. Although the sharp decline in heavy fuel oil use partly reflects the end to abnormally strong demand from the United Kingdom because of the coal miners' strike, end-use demand for heavy fuel oil in all the major consuming countries is declining. Complete data on recent oil consumption in less developed countries (LDCs) are unavailable, but fragmentary

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Table 1
OPEC: Crude Oil Production ^a

Million barrels per day

	Quota	1984 Average	1985			
			First Quarter	April Average	May Average	June ^b Average
Total	16.00	17.7	16.5	16.9	15.2	14.5
Algeria	0.66	0.7	0.7	0.7	0.7	0.7
Ecuador	0.18	0.3	0.3	0.3	0.3	0.3
Gabon	0.14	0.2	0.2	0.2	0.2	0.2
Indonesia	1.19	1.4	1.3	1.3	1.3	1.3
Iran	2.30	2.4	2.2	2.9	2.5	2.3
Iraq	1.20	1.2	1.2	1.3	1.3	1.3
Kuwait ^c	0.90	1.1	1.2	1.0	1.0	0.9
Libya	0.99	1.1	1.0	1.1	1.1	1.1
Nigeria	1.30	1.4	1.6	1.6	1.4	1.3
Qatar	0.28	0.4	0.3	0.3	0.3	0.3
Saudi Arabia ^c	4.35	4.7	3.9	3.6	2.7	2.2
United Arab Emirates	0.95	1.2	1.2	1.2	1.2	1.1
Venezuela	1.56	1.7	1.6	1.5	1.5	1.5

^a Columns may not add to totals shown due to rounding.

^b Preliminary.

^c Neutral Zone output is divided equally between Saudi Arabia and Kuwait and included in their production figures.

information and industry data suggest that LDC oil use this year is up a few hundred thousand barrels per day. At the same time, non-OPEC supply, which approximated 26.8 million b/d during the first half of 1985, was up about 500,000 b/d from average 1984 levels. [REDACTED]

Weak demand pushed OPEC crude oil production to 14.5 million b/d in June (see table 1, figure 2, and inset, *A Changing Market Environment*). In an attempt to placate the Saudis and relieve market pressure on heavy crude prices, a majority of OPEC members agreed to reduce heavier crude prices by as much as 50 cents per barrel in July. Members also agreed to discontinue price discounting (table 2). OPEC will deal with the issue of production quotas at a separate meeting scheduled for early October. Meanwhile, spot prices remain \$1 to \$2 below official levels [REDACTED]

The Outlook for OPEC Through 1986: No Relief in Sight

Non-Communist Consumption

We expect non-Communist oil consumption to register little or no increase in both 1985 and 1986 in response to slower economic growth and continued conservation and substitution. Under these circumstances, total oil consumption—excluding refinery gain—will approximate 45 million b/d in 1985 and 1986; our forecast is in line with recent industry estimates (tables 3 and 4). On the basis of the CIA linked econometric model and industry assessments, OECD energy consumption is assumed to rise by roughly 1.5 million barrels per day oil equivalent

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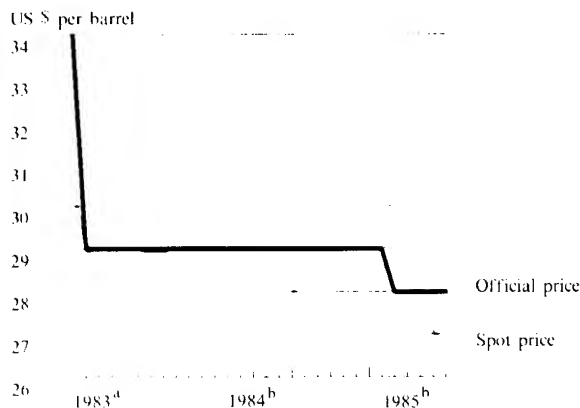
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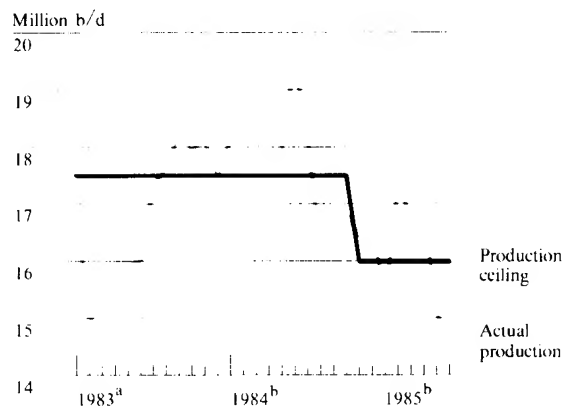
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Figure 2
OPEC: Price and Production Trends, 1983-85

Arab Light Crude Prices



Actual Crude Oil Production Versus Production Ceiling



^a1983
 February-March: OPEC agrees to reduce benchmark oil price \$5 per barrel and set crude oil production ceiling of 17.5 million b/d.

^b1984
 March-June: Iraqi-Iranian attacks on oil tankers keep demand for OPEC oil high. July: Excess inventories, continued high OPEC production, and rumored Saudi barter deal cause sharp fall in spot prices.
 October: North Sea producers and Nigeria cut oil prices \$1.35 to \$2 per barrel; OPEC holds special ministerial meeting, cuts production ceiling to 16 million b/d.
 December-January: After several false starts, OPEC agrees to realign differentials. Price of former benchmark crude, Arab Light, falls \$1 per barrel. OPEC members also agree to retain an independent auditor to monitor members' production.

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(b/doe) in 1985 and 1.4 million b/doe in 1986 (see inset, *Factors Affecting Oil Demand*, and figures 3 and 4). Oil consumption in OECD countries as a group, however, is expected to remain at or below 1984 levels in both 1985 and 1986 because of continued substitution. West European oil use is expected to drop in both years in response to substitution and relatively high prices caused by the strength of the US dollar. Consumption in LDC countries is expected to rise by a few hundred thousand b/d in both years.

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A Changing Market Environment

A number of changes in oil market behavior during the last year and a half added to market volatility and complicated OPEC's efforts to manage oil prices. These factors strain OPEC cohesion and undermine fragile market confidence in the organization's ability to maintain prices:

- *Spot oil deals and barter and countertrade activity accelerated dramatically last year as buyers moved away from generally more expensive term commitments.*
- *Increased trading in crude oil futures contracts decreased market emphasis on OPEC's role in setting oil prices. The rising volume of spot transactions increased producer uncertainty about future production and revenue levels and reinforced the need to stay competitive. Moreover, the increased volume of oil traded at other than official prices effectively reduced oil prices.*
- *OPEC countries also exported an increased volume of oil products, often at spot-related prices. These exports are providing several countries—including Algeria, Kuwait, and Venezuela—with a relatively easy outlet for discounted oil sales. OPEC product exports will continue to rise during the next two years, as more refinery capacity is added, and could approximate 3 million b/d by 1987, compared with about 1.5 million b/d last year.*
- *Although some non-OPEC producers—Mexico and Egypt, for example—initially responded favorably to OPEC overtures to reduce output, the failure of OPEC members to abide by production quotas caused non-OPEC cooperation to be short lived. Indeed, North Sea countries abandoned official prices in favor of market-related sales prices.*
- *Several OPEC members moved substantially away from commitments to restrict output. Nigerian willingness to reduce its official oil prices to raise exports heightened market perceptions of OPEC's loss of market control.*

As market pressures grew, OPEC members became increasingly adept at circumventing OPEC production accords:

- *A growing number of OPEC countries began reclassifying light crude oil as condensate to increase output while still nominally abiding by OPEC production restraints on crude oil.*

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about 92 days—and 100 million barrels above planned levels. Government-owned stocks account for about 600 million barrels of the total or about 14 days' supply. Expectations of lower oil prices and continued belt-tightening by the oil industry suggest oil companies will attempt to pare excess inventories in 1985. We assume non-Communist oil stocks will decline by 600,000 b/d in 1985 and will hold steady in 1986.

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Inventories

We estimate that primary oil stocks at the end of June 1985 stood at 4.0 billion barrels—enough to last

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Table 2
OPEC Countries: Strategies To Enhance Sales

	Saudi Arabia	Iran	Iraq	Kuwait	United Arab Emirates	Qatar	Algeria	Venezuela	Indonesia	Nigeria	Ecuador	Libya	Gabon
Exceeding quota		X	X	X	X	X	X	X	X	X	X	X	X
Spot sales		X	X		X	X					X		
Processing agreements								X		X		X	
Reclassifying light crude as condensate							X	X	X				
Barter/countertrade	X	X	X		X	X			X	X		X	
Preferential sales to Third World countries	X	X											
Transportation subsidies		X	X	X									
Product exports	X			X			X	X	X			X	
Open discounting		X									X		
Extended credit		X			X	X							
Producer allowance (easier tax policies)					X				X	X		X	

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Table 3
Non-Communist Oil Demand and Supply Outlook ^a

Million barrels per day

	1984					1985					1986	
	Quarters				Year	Quarters				Year		
	I	II	III	IV		I	II	III	IV			
Consumption	46.8	44.1	43.7	45.8	45.1	46.8	43.3	43.3	45.9	44.8	44.8	44.8
Inventory change	-1.3	2.0	0.6	-1.3	0	-2.3	0.4	0.2	-0.8	-0.6	0	0
Supply	45.5	46.1	44.3	44.5	45.1	44.5	43.7	43.5	45.1	44.2	44.8	44.8
OPEC	19.6	20.0	18.2	17.8	18.9	17.8	16.7	16.1	17.5	17.0	17.2	17.2
Non-OPEC	25.9	26.1	26.1	26.7	26.2	26.7	27.0	27.4	27.6	27.2	27.6	27.6

^a CIA estimates.

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Factors Affecting Oil Demand

Future oil demand is dependent on many variables, including economic conditions, conservation, and substitution—the key assumptions underlying our forecast. []

The Economic Environment. *We, like most forecasters, expect economic growth in the OECD countries as a group to approximate 3.3 percent in 1985, slightly below growth in 1984. A slowdown in domestic demand in the United States is expected to result in lower export growth for other OECD countries. Economic growth in the OECD is expected to average about 2.5 percent in 1986. These forecasts assume that nominal oil prices remain at about current levels and that the US dollar maintains its current position vis-a-vis other currencies.* []

Conservation. *Energy conservation gains are expected to continue, albeit at a slower rate during the period than experienced in the early 1980s. Many energy-saving investments continue to be profitable, and the impact of earlier conservation decisions—for example, in the design of buildings, machinery, and vehicles—is increasing. The move toward the service sector and away from energy-intensive heavy industries in the industrial countries also has dampened energy demand growth in the OECD. On the other hand, efficiency gains—as measured by the energy-to-GNP ratio—have slowed in recent years, partly reflecting falling real energy prices (figure 3). Indeed, where prices have fallen substantially, as in the case of gasoline in the United States, there are signs of reduced interest in conservation.* []

Substitution. *We expect continued increases in nonoil energy supplies in 1985 and 1986 in OECD countries—mostly in nuclear power, coal, and natural gas for use in electricity generation and the industrial sector. We estimate OECD oil consumption last year in both these sectors combined amounted to almost 10 million b/d. On the basis of industry assessments and analysis of nonoil capacity and sectoral consumption trends, we assume nonoil supplies in OECD countries will increase by 1.9 million b/doe in 1985*

and 1.4 million b/doe in 1986. Lower economic growth and a slowdown in incremental nuclear power supplies, especially in Western Europe, are largely responsible for the expected smaller increases in nonoil supplies in 1986. Despite the UK coal strike, we estimate that OECD nonoil supplies rose by about 1 million b/doe last year (figure 4). Overall we project:

- *Increases in nuclear power in all major regions will account for about half of the anticipated increase in nonoil energy supplies. Although environmental and financing problems are causing the US nuclear program to slow down, the existing construction backlog will lead to increased nuclear output over the next two years, and nuclear capacity will continue to grow sharply in Western Europe and Japan. Nearly a dozen reactors—capable of backing out heavy fuel oil equal to about 300,000 b/doe—are entering service this year in Belgium, France, West Germany, and the United Kingdom.*
- *Because coal will retain a significant price advantage in most markets, its use is assumed to rise by about 1 million b/doe over the period—with the United States accounting for most of the increase. Among foreign countries, Japan and some West European countries have the most potential for utility conversion from oil to coal. In Italy, for example, electric generating plants use about 400,000 b/doe, accounting for about half of total energy inputs in power plants.*
- *Natural gas demand is expected to rise in Western Europe, Japan, and the United States. Faced with surplus gas supplies in the short term, some West European countries are encouraging increased gas use. Japan favors liquefied natural gas over coal because of pollution concerns.*
- *Electricity from hydro generating plants is expected to rise by a few hundred thousand b/doe during the period.* []

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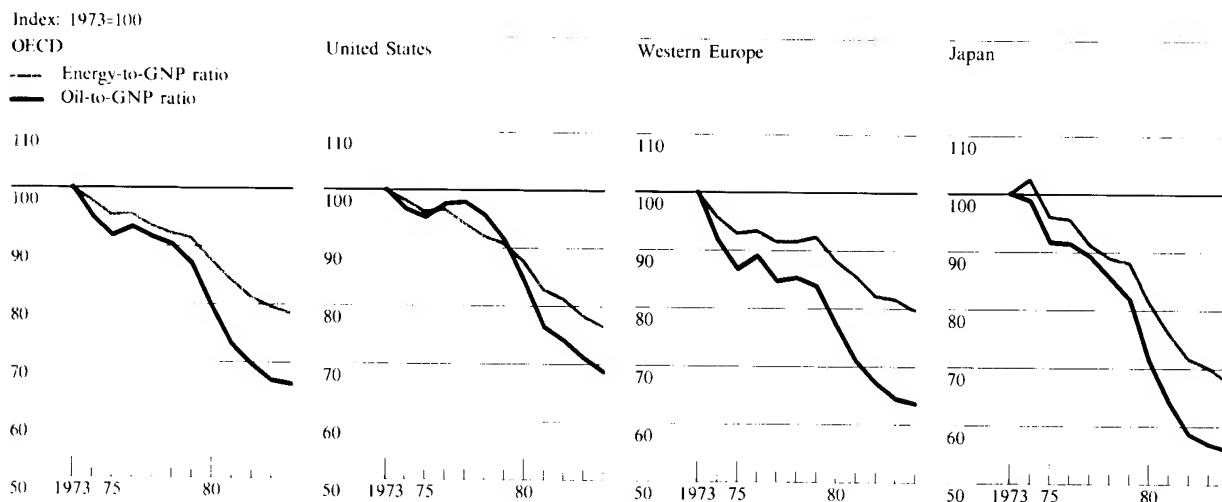
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Figure 3
Energy and Oil Efficiency Trends, 1973-84^a



^a The amount of energy and oil needed to produce a unit of GNP has declined sharply since 1973, indicating substantial efficiency improvements and substitution away from oil. From 1973 to 1984, the amount of energy used to produce a unit of GNP fell 20 percent in the OECD. Although the rate of decline slowed in 1984, OECD countries still cut the amount of energy needed per unit of GNP by roughly 2 percent.

Demand for OPEC Oil

Given our estimates of consumption, non-OPEC oil production and inventory behavior, demand for OPEC oil—including about 1.3 million b/d of natural gas liquids—will approximate only 17 million b/d in 1985 and 1986, causing demand for OPEC crude to remain at or below OPEC's current 16-million-b/d ceiling. This forecast indicates revenue pressures on OPEC members will mount; we estimate that at current prices OPEC production would have to average about 21 million b/d in 1986 to prevent a further decline in the foreign reserves of member countries (table 6). Moreover, demand for OPEC crude could fall substantially below the quota in response to seasonal changes in consumption. The already sharp fall in Saudi oil production has left Riyadh little room to reduce output further; since 1979 Saudi oil production has fallen almost 7 million b/d or roughly half of the

drop in OPEC production during the period (figure 5). If the decline in consumption continues, pressures on OPEC will rise. We estimate every percentage point change in consumption results in a 500,000-b/d change in demand for OPEC oil (see inset, *Oil Market Sensitivities*).

OPEC Wild Cards: Iran and Iraq

Developments in Iran and Iraq during the next 18 months could further exacerbate downward price pressure:

- Iraq continues its efforts to expand oil exports through construction of additional pipeline capacity. Even if the war continues, completion by early 1986

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Figure 4
OECD Energy Consumption,
1979 and 1985

Percent

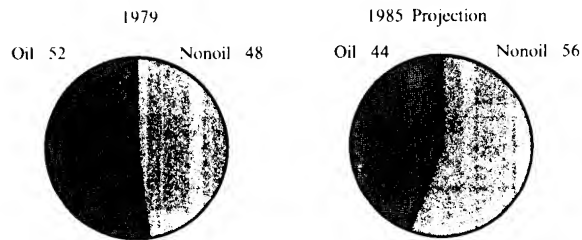
The effect of conservation and substitution

Table 5
Non-OPEC Production, by
Major Producers ^a

Million barrels per day

	1984	1985	1986
Total Non-OPEC supplies	26.2	27.2	27.6
United States	10.4	10.6	10.6
North Sea	3.5	3.8	3.9
Canada	1.8	1.8	1.8
Other OECD	1.0	1.1	1.1
Mexico	2.9	2.9	3.0
Other LDC	5.0	5.5	5.8
Net Communist Exports	1.6	1.5	1.4

^a Columns may not add to totals shown due to rounding.

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Oil Price Scenarios

The world oil demand outlook suggests OPEC will have difficulty holding the line on prices. While predicting the magnitude and timing of possible oil price declines is difficult, we have looked at several possible scenarios. 25X1

Price Stability

Although the organization's options for restoring price stability appear limited, certain developments could enable OPEC to maintain nominal prices:

of Iraq's spur line to Saudi Arabia's East-West pipeline to the Red Sea combined with the expansion of the Iraq-Turkey pipeline by early 1987 will increase Iraqi export capacity by about 1 million b/d. The Iraqi Oil Minister recently reasserted Iraq's entitlement to a production quota of at least 1.8 million b/d, an increase of 600,000 b/d.

- Iran may also attempt to increase exports further to raise revenue for the war. We estimate Tehran has the capacity to produce almost 3.5 million b/d.

In the event the war ends, Iran and Iraq could boost combined exports by 2 to 3 million b/d above current levels within several months. The decline in production in these two Persian Gulf countries since 1979 accounts for about 3 million b/d of the fall in total OPEC output and has been a major, if inadvertent, factor in helping the organization to prevent a sharp price decline. 25X1

- Saudi Arabia maintains its role as swing supplier and is willing to produce at levels far below 4 million b/d.
- Riyadh's threats that it will stop supporting prices if members continue to violate OPEC price and production guidelines cause some producers to be more cooperative. Iran and Iraq do not push for increases in their quotas.

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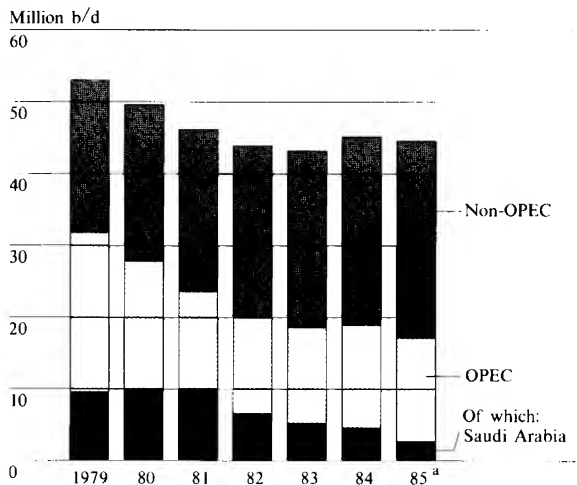
Table 6 *Million barrels per day*
OPEC: Estimated 1986 Minimum
Desired Oil Production ^a

	Production
Total	20.9
Algeria	1.2
Ecuador	0.3
Gabon	0.2
Indonesia	1.6
Iran	2.5
Iraq	1.6
Kuwait ^b	0.9
Libya	1.2
Nigeria	1.5
Qatar	0.3
Saudi Arabia ^b	6.2
United Arab Emirates	1.2
Venezuela	2.2

^a Oil production levels—including natural gas liquids—required to maintain foreign reserves constant in 1986.

^b Includes share of Neutral Zone production.

Figure 5
Non-Communist Oil Supply, 1979-85



^a Estimated.

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- The auditors' work on monitoring production and prices encourages greater discipline.¹

OPEC has demonstrated that at times it can close ranks to defend oil prices. Nevertheless, we believe that the organization will have difficulty maintaining the current price structure during the next few years unless underlying demand for OPEC oil rebounds in response to a faster-than-expected increase in oil consumption, or non-OPEC supplies do not reach anticipated levels.

¹ OPEC hired the auditing firm of Klynveld Kraayenhof and Company of the Netherlands to provide timely, accurate figures on members' production levels in the hope that additional transparency in OPEC country activities in the oil market would encourage stronger adherence to OPEC agreements. OPEC members agreed to receive visiting auditing teams and to make available requested documentation. Although the work of the auditors so far probably has not much affected production and pricing policies of OPEC members, the establishment of an objective reporting system will allow the singling out of OPEC members who have violated agreements and could cause the political fallout from any sharp price decline to be focused on these countries.

Controlled Descent

In this scenario OPEC members continue to undermine the official price structure, forcing a series of minicrises and price cuts:

- Saudi Arabia engineers several small price cuts that panic other producers, causing temporary periods of renewed OPEC discipline.
- Nigeria and Ecuador continue to produce above ceiling levels.
- Iran, Nigeria, the United Arab Emirates, and Ecuador discount oil in response to lower spot prices.
- Iraq's development of new export capacity encounters no major setbacks, and Baghdad begins producing more oil. Saudi Arabia and Kuwait cut back production for the Iraqi account, but on balance more OPEC oil enters the market.

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Oil Market Sensitivities

We have looked at the key factors that could alter our projected market outlook [redacted]

- A 1-percentage point change in GNP growth could change non-Communist oil consumption in the first year by about 300,000 b/d from the base case. Although this could mean higher demand for OPEC oil if economic growth exceeds expectations, most forecasters believe a slowdown in economic activity is a more likely alternative scenario.*
- Lower oil prices could cause a larger inventory drawdown over the near term. Should this occur, demand for OPEC oil might drop further and remain at very low levels through the summer months.*
- A \$2 per barrel drop in the price of OPEC oil could raise non-Communist oil consumption in the first*

year by about 100,000 b/d, although most of the impact of any reduction would take several years to work its way through the economy.

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- The increase in non-Communist consumption from a 10-percent drop in the value of the dollar vis-a-vis other currencies would be negligible—perhaps less than 100,000 b/d.*
- Forecasters have underestimated increases in non-OPEC supply availability in recent years, in part because expectations of future lower prices encourage maximum production now. If non-OPEC supply grows faster than expected, demand for OPEC oil will be lower.*
- Although competitive fuels still enjoy a substantial price advantage over oil, lower crude oil prices could dampen substitution plans.*

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- Demand for OPEC oil remains relatively flat in response to stagnant consumption and moderate increases in non-OPEC supply.*

Under these circumstances, prices eventually bottom out at \$20 to \$25 per barrel. [redacted]

Price Collapse

OPEC's discipline breaks down completely and members abandon efforts to maintain the price structure:

- Saudi Arabia stops supporting prices—perhaps by setting a “minimum acceptable production level” and reducing prices as necessary to maintain output—in response to widespread cheating by other OPEC members. Riyadh gambles that a sharp price break will force other producers to be more cooperative and believes a large price decrease is needed to ensure a sustained rebound in oil demand.*

- Iran and Iraq continue to force additional quantities of oil onto the market. Other countries are unwilling to absorb the necessary cutbacks, and competition for market share among producers becomes unrestricted.*

- Recession or greater-than-expected conservation and substitution cause oil consumption to fall and forces producers to scramble for market share.*

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- Companies attempt to liquidate inventories in expectation of lower prices.*

As a result, OPEC members compete openly for market share and prices drop below \$20 per barrel. [redacted]

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Policy Opportunities

A sharp fall in world oil prices would allow consuming countries to adopt more expansionary monetary and fiscal policies:

- *Energy-importing countries could raise energy taxes to improve their trade balances and reduce budget deficits.*
- *If increased taxes only partly offset lower oil prices, some of the benefits could be passed on to consumers at the same time that government revenues increased.*

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Oil-consuming countries also could implement policies that improve energy security:

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- *Tax policy changes could ensure that investments in conservation and nonoil energy development, as well as development of indigenous oil resources, remain attractive.*
 - *US allies could be encouraged to build strategic oil stockpiles while oil prices are depressed.*
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We are uncertain how far prices would fall or at what level they would stabilize under this scenario

and 1986. Under most circumstances, we believe the market will remain soft and real oil prices will continue to fall. Assuming that annual economic growth in the OECD averages 2.5 to 3.0 percent, non-Communist oil consumption is expected by most market forecasters to increase only slowly, perhaps by 1 percent annually or roughly 500,000 b/d. Conservation gains and increases in non-OPEC supplies and substitution away from oil are expected to continue—albeit at a declining rate—in response to falling real oil prices:

- *Oil production in OECD countries is generally expected to peak in 1986. Almost all industry forecasts predict US production will begin to fall by 100,000 b/d annually. Declines in Soviet oil production are expected to cause at least a 100,000-b/d fall in net Communist oil exports.*

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The Saudis have so far shown reluctance to abandon support of the current oil price structure and continue to emphasize the importance of OPEC unity. If pressure on Saudi output levels continues, however, Riyadh may feel compelled to follow through with its threat to boost production. Even if the Saudis are considering their longer term market concerns, the short-term revenue losses to other oil producers and the associated political costs to the Saudis of forcing a sharp price reduction would be viewed as extremely costly

Market Prospects Beyond 1986

The outlook for oil prices in 1987 and 1988 will depend primarily on the way events unfold in 1985

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- The weak oil market has slowed exploration in other areas of the non-Communist world. After more than 20 years of annual increases in capital and exploration spending by the oil industry, expenditures outside North America declined about 10 percent in 1983 compared with year-earlier levels. Preliminary data indicate that this trend has continued into early 1985.
- Most forecasters expect nonoil supplies in the OECD countries to rise at an average annual rate of 1.2 million b/doe during these two years. Lower projections of electricity demand growth and environmental concerns have slowed nuclear power developments. Forecasters expect nuclear power supplies in the major developed nations to rise at an annual average rate of 300,000 to 400,000 b/d. This compares with gains of 700,000 to 800,000 b/d in 1984 and 1985. []

Under these conditions, demand for OPEC oil could increase slowly to perhaps about 18-19 million b/d by 1988 and help encourage producer cooperation. Nevertheless, we expect excess available capacity to keep market conditions soft through 1988 and cause further erosions in real oil prices. A very sharp fall in nominal oil prices in 1985 or 1986 would hasten adjustments both in excess supply capacity and in demand by slowing substitution and conservation worldwide. []

Implications

The impact of a moderate decline in nominal oil prices on the world economy would be generally favorable.¹ In the industrial countries, lower oil prices would dampen inflationary pressures and provide opportunities for accelerating economic growth. Oil-importing LDCs would tend to benefit directly through lower import prices and indirectly as a result of higher demand for their exports and lower interest rates. Oil-exporting countries would suffer from lower revenue, and some—especially Egypt and Nigeria—could face heightened financial problems. A price drop of \$2 to

\$3 per barrel probably would not, however, significantly affect energy conservation or interfuel substitution, nor would it make any substantial amount of oil production unprofitable. []

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A sharp drop in oil prices—for example, to \$20 per barrel or lower, is unprecedented; and, while it would undoubtedly create substantial benefits it also could create some serious problems (see inset, *Policy Opportunities*). Economic performance in the West would be improved and oil-importing LDCs would receive some respite from their financial burdens, possibly raising prospects for political stability. The Soviet Union would be particularly hard hit if several of the factors that enhanced its trade performance during the last several years—low dollar commodity prices, depressed currency values in Europe, and high energy export receipts—were reversed. This could lead to lower imports of Western technology and equipment for industrial modernization and possibly the defense sector. []

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At least partially offsetting the gains is the risk that wide fluctuations in energy prices could induce some economic and political instability. Lower prices would seriously exacerbate financial problems in such oil-exporting countries as Mexico, Nigeria, Venezuela, and Indonesia and [] could lead to increased pressure on banks with substantial energy-related loans. In addition, a price collapse could strain moderate oil-exporting regimes in several regions and threaten US strategic interests by tilting power balances among Arab states toward more radical elements. []

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The impact of a major drop in oil prices on energy security would be equally important. Oil investments and development plans for some nonoil energy fuels would be postponed until the market stabilized—especially if prices fall below \$15 per barrel. Delays in the development of North Sea natural gas could open the door for greater Soviet penetration of the West European gas market in the 1990s. Moreover, interest in energy conservation might lag unless consumer fuel prices were kept high through increased energy taxes.

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These factors could undo the energy security gains achieved as a result of the response to the oil price shocks of the 1970s, hastening our return to greater dependence on vulnerable Persian Gulf oil. In any event, industrialized countries will remain vulnerable to major oil supply interruptions, particularly as surplus productive capacity becomes increasingly concentrated in the Middle East. In addition to the risk of a heightened Iran-Iraq war, state-supported terrorism could trigger a supply cutoff. At the same time, weak market conditions may cause a relaxation of contingency planning in consuming countries over the next few years and increase the West's vulnerability to another major oil supply disruption

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